Thus, the BOCs do not merely retain their historic *ability* to discriminate and engage in other anticompetitive conduct through their control of the local bottleneck. Their *incentive* to engage in such misconduct rises substantially when they enter long distance markets following the grant of section 271 relief and they must also compete for local service -- often against the very companies they compete with in long distance markets and which depend on BOC facilities to compete in both areas.

As the Notice (¶ 31) acknowledges, "the Commission previously has found that [the BOCs and independent LECs] might leverage their market power in the local exchange and exchange access markets through cost misallocation, raising their rivals' costs, improper discrimination to gain an advantage in the interexchange telecommunications services market, or a predatory price squeeze." Thus, the *LEC Classification Order* recognized that "as long as the BOCs retain control of local bottleneck facilities, they could potentially engage in improper cost allocation, discrimination, and other anticompetitive conduct to favor their affiliates' in region, interLATA services."[63] Moreover, their ability to engage in such conduct would be heightened by any sunset of section 272's separate affiliate requirements.

Subsequent experience has shown the accuracy of that prediction. First, as described by Dr. Selwyn, the BOCs have entered long distance markets only in their in-region

[63] *LEC Classification Order*, ¶ 134. It also made similar findings with regard to the independent LECs. *Id.*, ¶¶ 159-161. *See also Non-Accounting Safeguards Order* ¶¶ 9-13; *Verizon*, 122 S. Ct. at 1662 (The carrier that controls the "local loop plant" could "place conditions or fees . . . on long-distance carriers seeking to connect with its network"). Similarly, the Commission has found that "incumbent LECs . . . have the incentive and ability" to use their control over bottleneck facilities "to discriminate against competitors in the provision of advanced services" and to restrict their output. *SBC-Ameritech Merger Order* ¶ 186; *see id.* ¶¶ 196-97.

service areas, where they may exploit their local market power.[64] Except for services like calling cards that could be marketed to in-region customers, the BOCs have not sought to compete out of region. Notably, SBC does not even offer long distance services to local customers of CLECs or other ILECs in states where it has received section 271 authorization.[65] Second, as described below, the BOCs, including those that have long had interLATA authority, use their bottleneck control to misallocate costs and to discriminate against unaffiliated interLATA service providers. It is quite clear that the BOCs have in fact exercised their market power to harm interLATA competition in the ways the Commission anticipated in 1997 notwithstanding the existence of section 272 safeguards.[66]

The evidence compiled here shows that the BOCs' anticompetitive misconduct remains a serious problem today and will remain so long after any sunset of section 272 -- which would only make such misconduct even more difficult to detect and remedy. This danger was explicitly acknowledged by the Supreme Court, which recognized that "*In an unregulated world*, another telecommunications carrier would be forced to comply with the[] conditions" the incumbent local carrier imposed, or else the competing carrier "could never reach the customers of a local exchange."[67]

1. <u>BOCs Are Engaging in Price Squeezes By Setting Their Long Distance Rates At or Below Their Switched Access Prices.</u>

[64] Selwyn Dec., ¶ 32.

[65] *Id.*

[66] These following examples confirm both the BOCs' incentive and ability to harm long distance competition and their continuing local market power. The Commission has long recognized that evidence that a BOC is, in fact, able to misallocate costs or to engage in discriminatory conduct is direct evidence of market power. *E.g., SBC-Ameritech Merger Order* ¶ 107.

[67] *Verizon,* 122 S. Ct. at 1662 (emphasis added).

Because BOCs control the facilities used to provide access services, which are a key input into long distance services, the BOCs have strong incentive to price access services at rates above their cost. That, of course, enables the BOC to offer its own long distance services at prices that undercut those that can profitably be charged by rival IXCs. The Commission described the different ways in which the BOCs may price squeeze their IXC competitors as follows:

> "Absent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services. . . . The incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region, interexchange providers raised their prices to recover the increased access charges, the incumbent LEC's interexchange affiliate could seek to expand its market share by not matching the price increase. *The incumbent LEC affiliate could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.*"[68]

In describing how a BOC could engage in a price squeeze by setting its interexchange prices at or below its access rates, the Commission responded to BOC claims that any increased interexchange revenues could be offset by reduced access revenues from IXCs. In the *LEC Classification Order*, the Commission explained that: (1) the BOCs higher interexchange revenues would more than offset lost access revenues if the lower BOC interexchange rates sufficiently increased demand, and (2) the BOC would receive increased access revenues if IXCs reduced their interexchange rates to match the lower BOC interexchange rates.[69] As described below and in the attached Selwyn declaration, there is considerable evidence that BOCs -- including BOCs that have long held section 271 authority -- are in fact misusing their access bottlenecks by engaging in such price squeezes.[70]

Texas: As AT&T explained in a complaint with the Public Utility Commission of Texas, SBC's long distance affiliate has offered intrastate long distance services at very low rates that are nearly equal to SBC's intrastate access charges and thus could not possibly allow the SBC affiliate to cover all of its costs.[71] Some of the plans offered by SBC's long distance affiliate offer long distance service for as low as *6 cents* per minute for residential customers and as low as *7 cents* per minute for business customers. *AT&T Texas Price Squeeze Complaint* at 6-7. Yet the access charge that applies to a residential intrastate long distance call between SBC customers is about *5.67 cents* per minute. *Id.* at 7. On such calls, absent all other costs, SBC's affiliate would gain net revenue of just a few tenths of a cent. However, it is evident that the affiliate's own operating expenses are significant, and together with the access cost, far exceed the retail rates that SBC's affiliate is charging. Indeed, based upon agreements that SBC has summarized as a result of its section 272 obligations, AT&T has been able to estimate that the SBC long distance affiliate incurs billing and marketing expenses of at least 3.4 cents per minute. *Id.* at 8. However, even if the SBC long distance affiliate loses money on these calls, the SBC

[68] First Report and Order, *Access Reform Order*, 12 FCC Rcd. 15982, ¶ 277 (1997) (emphasis added).

[69] *LEC Classification Order*, ¶127.

[70] *See* Selwyn Dec., ¶¶ 43-48, 84-88, 96.

[71] *See* Second Amended Complaint of AT&T Communications of Texas, L.P., SOAH Docket No. 473-01-1558, Docket No. 23063 (Texas P.U.C. filed Dec. 5, 2001) ("*AT&T Texas Price Squeeze Complaint*").

entity as a whole has realized a net profit.[72] Based on these pricing patterns, SBC's long distance rates appear to be well below-cost, result in a price squeeze, and are anti-competitive. *Id.*

Virginia: Similarly, in a complaint recently filed with the Virginia State Corporation Commission, AT&T has explained that Verizon is using above-cost intrastate access rates to price squeeze AT&T and other IXCs.[73] Verizon's long distance affiliate offers long distance plans, particularly its bundled "Freedom" plans, that include unlimited long distance calling at effective retail rates that are substantially *lower* than its access charges to unaffiliated IXCs.[74] For the overwhelming majority of AT&T's Virginia in-state long distance calls, which continue to originate from and terminate to Verizon local exchange customers, AT&T pays access charges to Verizon averaging almost 8 cents per minute.[75] Because Verizon's net cost of providing originating and terminating access is less than one cent per minute, AT&T and other IXCs are providing a subsidy to Verizon of 7 cents per minute on all these calls.[76] At the same

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[72] SBC seeks to maximize the profit of the entire entity, and is indifferent to whether its long distance affiliate makes money. In fact, this was made particularly evident when SBC witnesses provided testimony before the Texas legislature regarding proposed tax legislation that would eliminate the ability of a surviving corporation in a merger to carry forward the losses of the other merged company. The SBC witness stated that SBC plans to merge its affiliates into its BOC operations when it is permitted, and that SBC will want to use the losses of those companies to offset any profits of the BOC. Partial Tr., Before the Senate Comm. on Finance, Austin, Texas, *Relating to the Franchise Tax*, S. Bill 1689 (Testimony of T. Leahy, SBC, Apr. 19, 2001).

[73] Petition of AT&T Communications of Virginia, LLC., *AT&T Communications of Virginia, LLC., v. Verizon Virginia, Inc., et al.*, PUC-2003-00091, May 8, 2003 ("*AT&T Virginia Price Squeeze Complaint*"). *See also*, Response of AT&T Communications of Virginia, LLC., *AT&T Communications of Virginia, LLC., v. Verizon Virginia, Inc., et al.*, PUC-2003-00091, Jun. 17, 2003 (*"AT&T Virginia Price Squeeze Response").*

[74] *AT&T Virginia Price Squeeze Complaint* at 4.

[75] *AT&T Virginia Price Squeeze Response* at 3.

[76] *See id.* at 4 & n.11.

time, Verizon's long distance affiliate is using this 7-cent per minute corporate access cost advantage to subject AT&T and other IXCs to an anticompetitive price squeeze through long distance plans pricing intrastate toll calls as low as 4 or 5 cents per minute.[77] Verizon's "Veriations Freedom" service is presently offered in five other states in addition to Virginia.

As noted by Dr. Selwyn, Verizon responded to AT&T's Virginia price squeeze complaint by contending that IXCs provided equivalent service packages -- but neglected to mention that IXCs can provide such packages only if they are also CLECs.[78] Significantly, Verizon made no claim that IXCs providing long distance services on a stand-alone basis -- which they must do to compete for the vast majority of mass market customers in BOC territories -- can compete with Verizon's long distance rates.[79]

Washington: AT&T has also shown that Verizon engages in anticompetitive price squeeze activities in the state of Washington, where Verizon's tariffed switched access charges and other costs are 13.44 cents per minute to provide intrastate toll services, yet all but two of its intrastate long distance toll calling plans for business and residential customers charge rates of 7.9 cents to 10.86 cents per minute.[80]

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[77] *AT&T Virginia Price Squeeze Complaint* at 3-4. *See also*, Selwyn Dec., ¶¶ 47-48 (showing that the average price of interLATA calling under Verizon "Freedom" plans is approximately 4.3 cents per minute).

[78] Selwyn Dec. ¶ 49.

[79] *Id.*

[80] Complaint, AT&T Communications of the Pacific Northwest, Inc., v. Verizon Northwest Inc., Dkt No. UT-020406, Apr. 3, 2002. *See also*, Affidavit of Lee L. Selwyn, Dkt. No. UT-030395, Washington Utilities and Transportation Commission, Apr. 14, 2003 (showing that Verizon's "Freedom" packages provide intrastate calling at 4.3 cents per minute, which is far below switched access charges).

As explained in Dr. Selwyn's testimony, the BOCs' own expert economists have themselves provided the theoretical explanation that corroborates the practical evidence of this pricing pattern.[81] These BOC economists claim that two affiliated companies that have a vertical supplier-customer relationship -- as do a BOC and its interLATA affiliate -- will engage in "double marginalization," which results in the companies setting the price of the "downstream product" (*i.e.*, long distance) to "maximize its profits jointly."[82] That occurs, these economists assert, because the BOC retains an "access margin," or access rates above cost, which makes it profitable for the entity as a whole to lower the price of long distance, regardless of the stand-alone profit of the downstream company.[83] Of course, if section 272 separation safeguards no longer apply, the incentives and ability to engage in such conduct are even greater.

2. <u>BOCs Are Engaging in Price Squeezes By Raising Their Special Access Rates.</u>

The BOCs also are using their special access bottlenecks to price squeeze IXC competitors in the other manner described in the Commission's *Access Charge Reform Order* -- by *raising* the price of special access services to all interexchange carriers, thus causing competing IXCs (as well as cellular, broadband and local service providers that also use the BOCs' special access services as essential inputs) "to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins."[84]

[81] Selwyn Dec., ¶ 62.

[82] *See id.* (citing BOC expert report).

[83] *Id.*

[84] *Access Reform Order*, 12 FCC Rcd. 15982, ¶ 277

Far from using special access pricing flexibility to *reduce* special rates to meet the competition that the BOCs claimed to exist in these services -- which was the principal purpose and central prediction underlying the Commission's *Pricing Flexibility Order* -- BOC special access rates are now higher in pricing flexibility areas than in price capped areas, and BellSouth, Verizon and Qwest have raised special access rates *in every MSA* in which they have received Phase II pricing relief.[85] BOC ARMIS reports show special access rates of return for 2001 of 49.26 percent for BellSouth, 46.58 percent for Qwest, 54.60 percent for SBC, and 21.72 percent for Verizon (or 37.08 percent for Verizon excluding NYNEX), as compared to the 11.25 percent rate of return the Commission found just and reasonable for dominant ILEC services in 1990. The BOCs are thus reaping huge monopoly profits.[86] Indeed, a study filed with the Commission on June 12, 2003, concludes that the Bells are receiving at least $5.6 billion in windfall profits annually through their exploitation of this last mile monopoly.[87] These excessive special access prices raise the costs of suppliers in downstream long distance, local services, cellular and broadband markets that rely on these services as essential inputs, and allow BOCs competing in these downstream markets to price squeeze their rivals.[88]

Moreover, the extent of the artificial competitive advantage in downstream markets the BOCs' special access bottlenecks confer is far greater than is shown by the BOCs'

[85] Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform*, et al., 14 FCC Rcd. 14221, ¶ 154 (1999) ("*Pricing Flexibility Order*"); AT&T Reply Comments, RM No. 10593, at 21-22.

[86] *See* AT&T Petition for Rulemaking, RM No. 10593, at 8 and Reply Declaration of Lee L. Selwyn Dec, Table 12.& Friedlander Dec. ¶¶ 2-4, Exhibit 1.

[87] *See* Rappoport, Taylor, Menko, Brand, *Macroeconomic Benefits from a Reduction in Special Access Price* (Jun. 12, 2003), filed in RM Docket No. 10593, at 5.

[88] AT&T Reply Comments, RM No. 10593, at 43-47.

ARMIS reports. That is because the BOCs' true costs of providing these services are their much lower forward-looking economic costs, rather than the embedded costs contained in ARMIS reports.[89] Indeed, the BOCs' special access rates are multiples of their economic costs, further demonstrating that these are monopoly services not subject to any meaningful competitive discipline, and that BOCs' downstream competitors that must rely on these services face a major competitive handicap.[90] A further demonstration of the huge advantages conferred by the BOCs' special access bottlenecks is the fact that they have more than a 90 percent share of *intra*LATA Frame relay and ATM services.[91]

3. The BOCs Have Abused Their Local Bottlenecks By Engaging In Other Forms of Discriminatory Conduct that Disadvantages Their InterLATA Competitors.

The *LEC Classification Order* predicted that "there are various ways in which a BOC could attempt to discriminate against unaffiliated interLATA carriers, such as through poorer quality interconnection arrangements or unnecessary delays in satisfying its competitors'

[89] AT&T Petition for Rulemaking, RM No. 10593, at 10-11.

[90] *See id.* & Stith Decl.

[91] AT&T Reply Comments, RM No. 10593, at 43-47. In a recent *ex parte*, Qwest cites to *national* market share statistics for ATM and frame relay services to bolster its claim that BOCs lack market power in the provision of broadband services to large business customers. *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities; Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket Nos. 02-33 and 01-337 and CS Docket No. 02-52, Letter dated May 23 2003 from Cronan O'Connell, Qwest, to Marlene H. Dortch, FCC. However, such statistics are irrelevant in assessing BOC market power because, until recently, the Bells have been restricted to local markets. The more pertinent question is how the Bells have fared in their provision of *local* data services, and the Qwest *ex parte* demonstrates convincingly that the BOCs have used their local bottleneck to dominate local data services. For example, Qwest's own submission shows that the BOCs account for 90.3 percent of frame relay services local revenues, and that no non-BOC accounts for more than 3 percent of such revenues. *Id.* at 15. The competitive picture is even bleaker with respect to ATM services. There, the BOCs account for roughly 97 percent of ATM local revenues. *Id.* at 16.

requests to interconnect to the BOC's network."[92] The accuracy of the Commission's predictions is confirmed -- once again -- by the BOC discriminatory conduct relating to the provisioning of special access, so-called "growth" discounts in switched access and the PIC process.

Provisioning of Special Access. One of the most competitively harmful ways in which BOCs are abusing their market power is in their discriminatory performance in providing special access services to IXCs that compete with the BOCs' interLATA affiliates. As described above, the BOCs retain significant market power over the provision of the special access facilities that are a critical input for IXCs. Timely and accurate provisioning, repair, and maintenance of special access services are critical for IXCs to make firm service commitments and to assure quality service for their end user customers.[93] BOC performance on these critical aspects of special access service shows a consistent pattern of poor quality, delays, and other discrimination against rival IXCs.

Several state commissions have investigated the BOCs' special access performance and determined that it is entirely inadequate and discriminatory. The NYPSC has ruled that the evidence before it demonstrated that Verizon "provides special wholesale services in a discriminatory manner."[94] The data compiled by the NYPSC suggested that Verizon missed very few provisioning appointments for its retail customers, but missed over 25 percent of

[92] *LEC Classification Order*, ¶ 111, citing *Non-Accounting Safeguards NPRM*, ¶ 139.

[93] *See NYPSC Special Access Order* at 10 (special access services "are crucial for the development of facilities-based competition").

[94] *Id.* at 6. The NYPSC found that Verizon's "provision of Special [Access] Services . . . began to deteriorate during 1995, and continued to decline in 1996." *NYPSC Special Access Order* at 4. Even "one full year" after the NYPSC acted to require Verizon to improve service quality, the "service results were mixed, at best." *Id.* at 4. Although some improvement was made in 1998
(continued . . .)

appointments scheduled by rival IXCs.[95] The NYPSC found that "these delays indicate Verizon's provision of Special [Access] Services is below the threshold of acceptable quality" and that "Verizon treats other carriers *less favorably* than its retail customers."[96] Significantly, these state commission findings of discriminatory performance were made for the local market that is the most developed in the country. Almost three years after Verizon's affiliate began providing in-region interLATA services, the PSC found that Verizon remained the dominant provider of special access in *all* areas of New York, and that its performance in providing those critical inputs was both inferior *and* discriminatory.

These NYPSC findings were corroborated by the Biennial Audit performed for Verizon. The audit collected data on four aspects of special access performance: average installation interval, installation commitments met, average repair interval, and total trouble reports. Even though the audit measurements were insufficient in a number of fundamental respects,[97] the limited data that were provided in the audit confirmed that Verizon's special access performance was blatantly discriminatory. For example, the data showed that installation of special access services for non-affiliated carriers took far longer than for Verizon 272 affiliates: in June, 2000, the mean for installation of high speed special access for Verizon

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(notably, the time period in which Verizon was seeking the NYPSC's support for its section 271 application), the NYSPC found that it "was not sustained." *Id.*

[95] *Id.* at 5.

[96] *Id.* (emphasis added).

[97] Most notably, Verizon simply failed to collect or maintain much of the data that is necessary to measure its special access performance. For example, the relevant performance data was often retained for a period shorter than the nine months that the audits attempted to examine. Comments of AT&T Corp. CC Docket 96-150, at 19 (filed Apr. 8, 2002); ("AT&T Audit Comments").

affiliates was just 9.9 days, but was 25.3 days for competitors.[98] In fact, review of virtually *every* report for each of the four special access performance measures indicates that Verizon's affiliates received more favorable service than competitors.[99]

Several other state commissions have also concluded that the BOCs' special access provisioning is inferior. For example, the Minnesota PUC, after reviewing a complaint filed by AT&T, concluded that there was a:

> clear need for further investigation, careful monitoring, and, potentially, wholesale access service quality standards for [Qwest, because] ensuring reliable, high quality long distance service between all Minnesota households and businesses is one of this Commission's highest priorities. The record in this case raises the serious possibility that the quality of [Qwest's] wholesale access services may jeopardize this important goal.[100]

Likewise, in another state complaint case, the Colorado Public Utilities Commission found serious problems with special access provisioning:

> AT&T has experienced regular, frequent, widespread, and ongoing delays in obtaining access . . . When [Qwest] does not meet its dates for the provision of service, it works a hardship on AT&T as well as AT&T's customers . . . On a region-wide, multi-state basis, [Qwest] has provisioned DS1s and DS0s to AT&T on a wholesale basis after a longer interval than it provided those same services to other wholesale customers.[101]

These findings are all the more significant because publicly available data on BOC special access performance is generally inadequate -- often because the BOCs have insisted

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[98] *See* AT&T Audit Comments at 19-22 & Bell Decl. ¶¶ 43-44.

[99] *See* AT&T Audit Comments at 19-20 (citing Verizon Audit, Table 14a, 14b. 14c).

[100] MPUC Docket No. P-421/C-99-1183, *Complaint of AT&T Communications Of the Midwest Inc. Regarding Access Services*, 2000 Minn. PUC Lexis 53, *34 (Aug. 15, 2000).

[101] CPUC Docket No. 99F-404T, *AT&T Communications of the Mountain States, Inc. v. U S West Communications, Inc.*, Decision No. R00-128, at II.D, F, G (Feb. 7, 2000); *see also* Comments of Texas Public Utility Commission, CC Dockets 96-98, 98-147, 01-337, at 5 (filed March 18, 2002) (noting its investigation of SBC's provision of special access).

upon hiding such data from the public view. Additionally, the findings and data on special access performance collected by state commissions are limited because many of them have hesitated to assert jurisdiction over the BOCs' performance in providing special access services, which are used primarily for interstate traffic.[102] Moreover, although ILECs provide service quality data to IXCs for business purposes, such data are typically subject to confidentiality agreements that forbid IXCs from disclosing the data, or that require IXCs to seek ILEC approval before doing so. Further, although the Biennial Audit report for SBC in Texas was released on December 17, 2001, SBC redacted *all* of the performance data for special access services -- notwithstanding the Commission's express holding that public comment on such data is a "critical component[] in ensuring compliance with the separate affiliate safeguards and promoting competition in the market for in-region interLATA telecommunications."[103]

In fact, the performance data SBC sought to keep secret showed that SBC's affiliates received better performance in *each* of the last seven months audited -- and the largest differences were in the last two months reported, confirming that SBC's performance was decreasing.[104] The data also show that SBC's return of firm order confirmations on DS1 and DS3 facilities were longer for SBC's rivals than for its affiliates in *all* 18 of the instances where the measure employed showed a performance difference. Likewise, SBC's competitors virtually always suffered longer delays for restoration of trouble than SBC's affiliates.[105]

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[102] *See* AT&T Special Access Comments at 21.

[103] Memorandum Opinion and Order, *Accounting Safeguards under the Telecommunications Act of 1996: Section 272(D) Biennial Audit Procedures,* 17 FCC Rcd. 1374, ¶ 12 (2002)

[104] *See* Comments of AT&T Corp at 17-25, CC Docket No. 96-150 (filed Jan. 29, 2003).

[105] *Id.*

Despite the BOCs' efforts to suppress data regarding their special access performance, AT&T has submitted testimony to the Commission that, on a national, aggregated basis, tracked performance trends for special access over the last five years.[106] That analysis demonstrated that ILECs consistently failed to provision DS-1 orders in a timely manner -- in the five years AT&T examined, the ILECs' failure rate was as high as 23 percent, and it never fell below 10 percent.[107] Moreover, the data reflected a *downward* trend in on-time performance. And AT&T's national data also showed that ILECs failed to respond to outages in a timely fashion.[108]

"Growth" Discounts. The BOCs have also used their market power to discriminate against rivals and in favor their affiliates in rates for switched access services. The Commission has already given special attention to schemes by which a BOC may be able to establish rates that appear to be facially neutral, but in fact have an unlawful, discriminatory impact. In the *Non-Accounting Safeguards Order*, the Commission recognized that "a BOC may have an incentive to offer tariffs that, while available on a nondiscriminatory basis, are in fact tailored to its affiliate's specific size, expansion plans, or other needs."[109] Similarly, the Commission elsewhere has specifically noted that "growth discounts," which offer reduced

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[106] *See* Declaration of Maureen Swift on Behalf of AT&T Corp. CC Docket 01-321 (Appended to AT&T's Reply Comments filed Feb. 12, 2002).

[107] *Id.* ¶¶ 10-12.

[108] *Id.* ¶ 12.

[109] *Id.* ¶ 257.

prices based on growth in traffic, "create an artificial advantage for BOC long distance affiliates with no subscribers, relative to existing IXCs and other new entrants."[110]

The Commission has also recognized that BOC affiliates, which "will begin with existing relationships with end users, name recognition, and no subscribers," will be able to "grow much more quickly than existing IXCs and other new entrants."[111] It has further recognized that "incumbent LECs could circumvent the nondiscrimination provisions of section 272 by offering growth discounts for which, as a practical matter, only their affiliates would qualify."[112] In light of this risk, and finding that growth discounts offered "no affirmative benefit" to the development of competitive access markets, the Commission expressly prohibited the use of growth discounts in interstate switched access service tariffs.[113]

Despite this ruling, BellSouth last year filed a tariff establishing a discriminatory growth discount favoring BellSouth's long distance affiliate ("BSLD") over large, established IXCs such as AT&T.[114] BellSouth's tariff offered discounts based on percentage growth from a fixed customer base, and thus had a discriminatory impact on established IXCs because they start with a large customer base, from which it is difficult to grow annually on a high percentage basis.[115] BSLD, on the other hand, begins with a very small customer base. As BSLD enters

[110] *Pricing Flexibility Order,* ¶ 134.

[111] Notice of Proposed Rulemaking, Third Report and Order and Notice of Inquiry, *Access Charge Reform Price Cap Performance Review of Local Exchange Carriers,* 11 FCC Rcd. 21354, ¶ 192 (1996).

[112] *Id.*

[113] *Access Charge Reform NPRM,* ¶ 135.

[114] *See* Comments of AT&T Corp., WC Docket No. 02-150, at 47-51 (filed July 11, 2002) ("AT&T Alabama 271 Comments").

[115] *See* AT&T Alabama 271 Comments & King Decl. ¶ 12.

interLATA markets, it can leverage BellSouth's monopoly customer base into a large share of long distance markets, mostly at the expense of the large IXCs. Thus, even though AT&T's total access minutes are significantly larger than those of BSLD, BSLD would show "growth" in its initially small volumes, and on that basis obtain a larger volume discount and lower access charges than AT&T and other large IXCs.[116]

PIC Process and PIC Freezes. Vital and robust competition in interLATA markets is also critically dependent upon the PIC process, the method for a customer to change its primary long distance carrier that allows IXCs to win interLATA customers in a rapid and efficient manner. Because of their dominance in local markets, BOCs retain control over the PIC process.[117] As a consequence, BOCs have obvious incentives to use the PIC change process in myriad ways to favor their long distance affiliates and customers. The BOCs, for example, not only implement PIC changes for their affiliates more quickly, but also engage in myriad additional forms of discrimination, such as routinely placing a "PIC freeze" (a process which makes it more difficult for a customer to change its local carrier) on customers that select BOC affiliates' long distance services. Even though data relating to the PIC process is even more limited than data on special access, there is substantial evidence that BOCs have manipulated that process to favor their interLATA affiliates and to discriminate against rival IXCs.

For example, a California ALJ last year determined that "a substantial possibility of harm to the intrastate long distance telephone market exists from [the BOC's] continuing role

[116] *Id.* ¶ 6.

[117] *See* Second Report and Order and Further Notice of Proposed Rulemaking, *Implementation of Subscriber Carrier Selection Changes Provisions of the Telecommunications Act of 1996*, 14 FCC Rcd. 1508, ¶ 116 (1998).

as the [PIC] administrator."[118] The ALJ recognized that there is a "tension between Pacific's duty to administer PIC changes in a competitively neutral way and its interest in winning customers."[119] The ALJ found that Pacific Bell "failed to offer any assurance that it would perform its [PIC administrative] role with any safeguards of neutrality or sensitivity to competitor concerns."[120] In doing so, the Judge relied on a partial audit that found "problems with a significant percentage of" disputed PIC changes administered by Pacific. Accordingly, the California ALJ concluded that, unless PIC changes were handled by a neutral administrator, "there is a substantial possibility that the intrastate interexchange telecommunications market will be harmed through increasing customer dissatisfaction and carrier conflicts."[121]

In Colorado, Qwest unilaterally extended PIC freezes the day that intraLATA presubscription was implemented -- the first time that customers were able to choose their intraLATA carrier. By extending the freeze to the intraLATA carrier, Qwest froze *itself* as virtually all customers' carrier, thus impeding customers' ability to choose a carrier other than Qwest. Qwest rejected thousands of customers' orders to switch away from Qwest. AT&T and other carriers were forced to file complaints regarding Qwest's action, and an ALJ found that the institution of the freeze was unlawful.[122] The ALJ found that Qwest "used its position as the sole 1+ intraLATA provider in its extensive service area to inhibit the entry of competitors into the

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[118] *California ALJ Decision,* at 245.

[119] *Id.* at 247-248.

[120] *Id.* at 288.

[121] *Id.* at 300.

[122] *Before the Public Utilities Commission of the State of Colorado,* Docket No. 99K-193T, Decision No. C00-301, March 22, 2000.

intraLATA market and tangibly damaged the entering competitors," and that Qwest's "abuse of *its market position to inhibit and damage competition was anticompetitive.*" [123]

The BOCs have also caused significant harm to interLATA markets by manipulating the PIC freeze process. In particular, AT&T and other IXCs have provided evidence that Verizon persistently abused its ability to discriminate in the administration of the PIC freeze process to advantage its own toll services and disadvantage its New York competitors.[124] For example, IXCs have shown that Verizon (i) imposed PIC freezes on its own toll accounts without customer consent (thus making it more difficult for rivals to switch over customers they win from Verizon), (ii) disrupted the three-way calls that are typically used to lift PIC freezes, and (iii) gave preferential treatment to customers who were selecting Verizon long distance, but who had PIC freezes on their toll lines.[125] In addition, AT&T's evidence to the New York PSC demonstrated that Verizon personnel would often simply ignore or override a customer's valid PIC freeze when seeking to convert that customer to Verizon long distance.[126]

This problem does not disappear with section 271 approval or the passage of time. The Verizon biennial audit collected information regarding Verizon's processing of PIC changes. Even though the audit examined only a single aspect of that process, the data collected in the audit provided significant evidence of discrimination: in all five months covered by the audit, it took substantially longer for Verizon to implement competitors' PIC changes than those of

[123] *Id.* at 10.

[124] *See* Letter of Harry M. Davidow, AT&T, to Hon. Janet H. Deixler, New York, P.S.C., Cases No. 00-C-0897 et al (Jan. 18, 2002).

[125] *Id.* at 2.

[126] *Id.* at 4.

Verizon's affiliates.[127] In one month, for example, it took Verizon over three times as long to process competitors' PIC changes.[128]

4. BOCs Have Engaged in Cost Misallocations That Distort Competition in InterLATA Markets.

BOC market power over local exchange and exchange access also provides them with the ability to allocate costs and otherwise structure their local operations in a manner that favors the BOCs' own long distance operations and harms those of competitors.[129] The *LEC Classification Order* recognized that "improper allocation of costs by a BOC is of concern because such action may allow a BOC to recover costs from subscribers to its regulated services that were incurred by its interLATA affiliate in providing competitive interLATA services."[130] The Commission further recognized that "[I]n addition to the direct harm to regulated ratepayers, this practice can distort price signals in [competitive interLATA service] markets and may, under certain circumstances, give the affiliate an unfair advantage over its competitors."[131]

As Dr. Selwyn describes, the BOCs have in fact misallocated costs in this way, and have thus used their local service bottlenecks to cross-subsidize competitive interLATA services even while they have been subject to the section 272 safeguards Congress established

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[127] AT&T Audit Comments at 18 n.11, 19-20 & Bell Dec. ¶ 45.

[128] BOC "tying" arrangements between local and intraLATA toll services further demonstrate how local bottlenecks may be leveraged into long distance markets. *See* Selwyn Dec ¶¶ 71-72.

[129] *See Verizon*, 122 S. Ct. at 1662.

[130] *LEC Classification Order*, ¶ 103, citing *Non-Accounting Safeguards NPRM*, ¶ 135.

[131] *Id.*

specifically to prevent such anticompetitive misconduct.[132] For example, by virtue of the BOCs' monopoly status, they acquired a massive customer base as well as ready access to a steady stream of inbound, customer-initiated contacts.[133] As a 2002 audit report in California described, BOCs such as Pacific Bell have over many years developed extensive and massive customer databases, which contain substantial and valuable customer information, including customer names, addresses, and phone numbers, as well as "detailed historical information concerning customer telecommunications services and credit."[134] The BOCs have used these advantages to provide marketing services and assets to their interLATA affiliates at reduced costs or even free of charge.

As the California ALJ described in crediting a competing carrier's testimony regarding a proposed BOC marketing plan, the BOC long distance affiliate, "through its position as the incumbent, . . . obtains marketing access to millions of potential interLATA customers at a cost that is far below either the cost to the RBOC to produce the joint marketing services, or the fair market value of the service."[135] The ALJ cited to evidence showing that, although the fair market value of new customer acquisition ranged from about $300 to $500 per sale, the BOC long distance affiliate was paying the BOC a mere $3.54 per sale.[136] The ALJ determined that

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[132] Selwyn Dec., ¶¶ 58-70. *See also, LEC Classification Order*, ¶ 103("Recognizing this concern, Congress established safeguards in section 272, which we have implemented in the *Non-Accounting Safeguards Order* and *Accounting Safeguards Order*.")

[133] Selwyn Dec., ¶¶ 52-53, 55.

[134] Supplemental Report, Regulatory Audit of Pacific Bell for the Years 1997, 1998, and 1999 at S12-4, S12-6 (prepared for the Cal. PUC by Overland Consulting, dated June 20, 2002) ("*Overland Supp. Cal. Audit*").

[135] *California ALJ Decision* at 251-52.

[136] *Id.* at 252 n.376.

the BOC's "proposed joint marketing plan clearly demonstrates cross-subsidization, and we find *it very troubling" -- in particular because of the "economic detriment [to] the local ratepayers."*[137] The ALJ concluded that the BOC needed to "re-examine" its plans, and warned that, if cost misallocation was later uncovered in the final plans, "we will not hesitate to take the strongest action."[138]

In addition to marketing services, BOCs also apparently provide their interLATA affiliates with free access to the valuable BOC customer databases. The 2002 audit of Pacific Bell discovered that "SBC began transferring Pacific Bell's customer service, marketing, and sales functions to SBC Operations, a corporate shared services affiliate."[139] The transfers also include "Pacific Bell's customer database," but the auditors determined that "Pacific Bell has not been compensated for the transfer."[140] That is entirely unjustified, because the auditors noted that the data could "be used for a variety of purposes by a wide range of subsidiaries" -- including SBC's long distance affiliates.[141] The auditors found that "the most obvious benefit provided by access" to the database is "sales leads," but other benefits included the ability to develop "marketing strategies" and to "piggyback" on the database in order to "maintain an ongoing

[137] *Id.* at 252.

[138] *Id.* at 253.

[139] *Overland Supp. Cal. Audit* at S12-1.

[140] *Id.* The auditors requested information from Pacific about the transfer in June, 2001, but did not receive responses for about 9 months – which is why a supplemental report was required. *Id.* at S12-1 to S12-2. The responses indicated that Pacific Bell was compensated only for the customer service labor in providing marketing services and for sales referrals, which generated about $8 million annually for Pacific Bell (*id.*) – an unconscionably low number given the market rate for referrals and the fact that other intangible assets (such as the rights to the SBC corporate name) were billed at much higher rates. *See id.* at S12-7.

[141] *Id.* at S12-7; S12-1.

picture of their relations between their customer and their service base."[142] Given the "evident" and "definable benefits," and other "advantages that inure to affiliates with access to a complete local exchange . . . database," the auditors concluded that the value of the access to the database was "worth at least as much" as $400 million, the amount Pacific Bell paid SBC for the rights to the SBC corporate name.[143]

In addition, as shown by Dr. Selwyn, even while subject to the section 272 affiliate transaction rules designed to prevent cost misallocation, SBC and Verizon have structured the pricing of their billing and collection services with discounts for which only their own long distance affiliates are likely to qualify because they require a commitment of 85 percent of a carrier's in-region billing to the BOC regardless of actual volumes.[144]

Accordingly, there is overwhelming evidence of BOC anticompetitive conduct following the grant of section 271 relief, notwithstanding Commission predictions that safeguards other than dominant carrier regulation of BOC long distance affiliates would adequately address such conduct. Moreover, as consumers increasingly purchase bundled long distance and local services, the adverse effects of such anticompetitive conduct extend beyond long distance markets. As the *LEC Classification Order* further noted, "degrading a rival's interexchange service may also undermine the attractiveness of the rival's interexchange/local exchange package and thereby strengthen the BOC's dominant position in the provision of local exchange services."[145]

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[142] *Id.* at S12-4, S12-7.

[143] *Id.* at S12-5, S12-7.

[144] Selwyn Dec., ¶ 66.

[145] *LEC Classification Order*, ¶ 111.

III. DOMINANT CARRIER REGULATION IS ESPECIALLY CRITICAL IF BOCS PROVIDE LOCAL AND LONG DISTANCE SERVICES ON AN INTEGRATED BASIS

By providing local and long distance services through a single entity, the BOCs are able to engage in price squeezes, cost misallocation and discrimination with much less risk of detection and could rapidly leverage their local bottlenecks to remonopolize long distance markets. To limit such misconduct, the BOCs should be regulated as dominant carriers following any sunset of section 272.

Because of their market power over virtually all exchange and exchange access services, "incumbent local exchange carriers are generally treated as dominant carriers," and the dominant carrier classification applies to all of their services "absent a specific finding to the contrary for a particular market."[146] As the Commission acknowledged in the *LEC Classification Order*, dominant carrier regulation limits the ability of dominant carriers to raise rivals' costs and engage in other anticompetitive conduct. Moreover, as described in Section IV below, the present nondominant treatment of BOC long distance affiliates was predicated on other regulatory safeguards that would not be available to prevent such misconduct after sunset of section 272. Accordingly, until the Commission adopts all of the reforms necessary to prevent BOC price and non-price discrimination through abuse of their local bottlenecks, dominant carrier regulation is required.

1. Dominant Carrier Regulation is Necessary to Deter and Detect the Abuse of BOC Market Power.

[146] *See* Notice of Proposed Rulemaking, *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services,* 16 FCC Rcd. 22745, ¶ 5 (2001)..

BOC provision of local and long distance services on an integrated basis following any sunset of 271 would allow them to make much greater use of their access cost advantage and entrenched local service monopoly to favor their long distance services with little near-term risk of detection. As described by Dr. Selwyn, the BOCs seek "to operate their competitive businesses *incrementally* with respect to their core monopoly local service business" and "[u]nder this theory the captive local service customer pays the entire cost of all jointly-used network facilities and organizational resources."[147] Because no CLEC will have a comparable share of the local service business in any BOC region for many years to come, if ever, even IXCs that are also CLECs cannot compete on a level footing with BOCs that use their local service bottleneck to cross-subsidize their long distance services in this way.

The Communications Act requires the elimination of such market power abuses. The Act requires that "[a]ll charges, practices, classifications and regulations for and in connection with . . . communications service . . . shall be just and reasonable."[148] Any charge, practice, classification or regulation that is "unjust or unreasonable is . . . unlawful."[149] The Commission's dominant carrier regulations consist of tariffing and related filing requirements that help enforce §§ 201-202 of the Act.[150] As the Supreme Court has stated, "[t]he tariff-filing

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[147] Selwyn Dec., ¶ 91.

[148] 47 U.S.C. § 201(b).

[149] *Id.*

[150] *See id.*, §§ 61.31 *et seq.* *See also,* First Report And Order and Further Notice of Proposed Rulemaking *Promotion of Competitive Networks in Local Telecommunications Markets, et al.*, , 15 FCC Rcd 22983, ¶ 134 (2000) ("It is well established that the Commission has broad authority to regulate the practices of LECs in connection with their provision of interstate communications services. In addition to the general authority specified in Title I of the Communications Act, Title II [and in particular §§ 201 and 202] provides a specific, substantive framework for the Commission's regulation of such practices.").

requirement is . . . the heart of the common-carrier section of the Communications Act."[151] Where market power is absent, competitive forces generally ensure enforcement of the central common carrier goal of just, reasonable and nondiscriminatory rates. Where market power exists, however, without the transparency provided by the tariffing requirement, "[t]he provisions allowing customers and competitors to challenge rates as unreasonable or as discriminatory would not be susceptible of effective enforcement."[152]

For that reason, dominant carriers are required to file tariffs that disclose not only the carriers' rates (and other terms and conditions of service),[153] but also supporting data,[154] including when rates are changed, and supporting "economic information."[155] By providing notice (ranging from a minimum of one day's notice for new services of price cap LECs to fifteen days' notice for rate increases to existing services),[156] a tariff "allows both the FCC and affected customers to review and challenge price changes."[157] When the Commission determines that a tariff does not sufficiently show that the rates and charges contained therein are "just and reasonable," the Commission may reject the tariff and order refunds.[158] Perhaps most critically,

[151] *MCI Telecommunications* v. *AT&T*, 114 S. Ct. 2223, at 2225 (1994).

[152] *Id.* at 2231; *see also AT&T* v. *Central Office Tel.*, 118 S. Ct. 1956, at 1962 (1998) (concluding that tariffs are required in order to "prevent[ ] unreasonable and discriminatory charges").

[153] 47 U.S.C. § 203(a); 47 CFR. § 61.33.;

[154] *See generally* 47 C.F.R. § 61.38.

[155] *Id.*

[156] *See* 47 C.F.R. § 61.58.

[157] *WorldCom, Inc.* v. *FCC*, 238 F.3d 449, 454 (D.C. Cir. 2001).

[158] *See, e.g., Southwestern Bell Tel. Co.* v. *FCC*, 138 F.3d 746, 752 (8th Cir. 1998) (affirming Commission decision to reject LEC tariffs that failed to justify their costs). At the same time, the Commission has acted to reduce the costs of tariffing by, for example, permitting electronic filing. *See, e.g., 1998 Biennial Regulatory Review – Part 61 of the Commission's Rules &*
(continued . . .)

however, the tariff requirement may deter some market power abuses in the first instance, because the transparency that tariffing provides makes it more likely that misconduct will be detected and punished.[159] The Commission has affirmed that such prior notice of changes in rates and service offerings "is necessary particularly in markets where there is a dominant service provider because it permits consumers or the Commission to challenge potentially unlawful rates before they become effective."[160]

As described by Dr. Selwyn, dominant carrier tariff filing and cost support requirements protect against price squeeze conduct by ensuring that rates are supported by all relevant costs, including both access and non-access costs, such as sales and marketing, billing and collection, uncollectibles, customer care, and other network costs.[161] In this regard, the application of the non-sun setting section 272(e)(3) access imputation requirement alone could not prevent below-cost pricing, because, as noted by Dr. Selwyn, non-access costs indisputably are greater than zero, and therefore "the presence of any non-access costs would place rival IXCs in a price squeeze if the BOC's retail price fails to cover such non-access costs."[162] Accordingly,

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Related Tariffing Requirements, Report and Order and First Order on Reconsideration, 14 FCC Rcd. 12293, ¶¶ 5-6 (1999). Thus, tariffing is an increasingly efficient way for the Commission to ensure that it, and all interested parties, can test the reasonableness of dominant firms' rates and charges.

[159] *See* Selwyn Dec. ¶¶ 6-8. Currently, the Commission's maximum penalties are not adequately severe, and the ILECs view them as a mere cost of doing business. AT&T addresses this issue in more depth in other ongoing proceedings. *See Performance Measurements and Standards for Interstate Special Access Services*, CC Docket No. 01-321 (Jan. 22, 2002); *Performance Measurements and Standards for Unbundled Network Elements and Interconnection*, CC Docket No. 01-318 (Jan. 22, 2002).

[160] *Comsat Corp.*, 13 FCC Rcd. 14083, ¶ 153 (1998).

[161] Selwyn Dec., ¶¶ 77-78, 88, 93, 102.

[162] *Id.*, ¶ 88.

section 272(e)(3) does not "provide adequate safeguards to deter anticompetitive behavior." Notice, ¶ 46. Dominant carrier regulation, unlike the section 272(e)(3) imputation requirement, ensures that a BOC's prices cover *all* relevant costs, including both *access* costs and *non-access* costs.

Critically, however, BOC compliance with dominant carrier cost support requirements for access should be based upon the imputed access cost required by section 272(e)(3). If the BOCs were allowed to comply with dominant carrier cost support requirements based on the economic cost of access to a BOC, while unaffiliated IXCs continued to pay above-cost access rates, the BOCs would still be able to make anticompetitive use of their access cost advantage to price squeeze rival carriers. As described below, section 272(e)(3) remains a necessary safeguard, and should be used to determine BOC compliance with dominant carrier rules, for as long as IXCs must pay access rates that are above the access costs incurred by ILECs in providing their own long distance services.

Thus, the Commission also should adopt rules to ensure compliance with section 272(e)(3) by requiring the BOCs to impute access costs for each identifiable service offering, including each component in a bundled offering of multiple services.[163] As noted by Dr. Selwyn, the BOCs frequently attempt to satisfy such requirements across the aggregate of their long distance services, thus using high margin services such as operator assisted calls to subsidize

[163] *Id.*, ¶ 92.

discounted toll plans that, by themselves, would fail imputation.[164] *Service by service* imputation requirements are necessary to prevent such anticompetitive cross-subsidization.[165]

Dominant carrier regulation is also necessary to prevent cost misallocation. As described by Dr. Selwyn, "the presence of substantial joint costs raises the spectre of serious misallocation of those costs."[166] Notably, "[w]ithout dominant carrier regulation and full tariff and cost reviews, there is little practical means even to identify, let alone correct, efforts by the then-integrated BOCs to assign as much of these joint costs to their regulated operations as possible or to shift joint costs out of competitive services and over to monopoly services so as to support discriminatory pricing of their competitive services."[167] Therefore, the dominant carrier tariff review process should also address "the manner in which the joint costs of functions supporting both the BOCs' local and long distance services are allocated as between these two categories."[168]

The Commission recognized in the *LEC Classification Order* that "certain aspects of dominant carrier regulation might constrain a BOC's ability to raise the costs of its affiliate's interLATA rivals or engage in other anticompetitive conduct."[169] The Commission also noted that the tariff filing and cost support requirement "might help to detect and prevent predatory

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[164] *Id.*, ¶¶ 76, 89.

[165] Similarly, the BOCs should not be allowed to avoid the imputation safeguard by using different access facilities from those provided to competing IXCs and imputing the cost of those different facilities rather than the facilities used by IXCs. The relevant access costs for imputation should be those paid by unaffiliated IXCs, irrespective of any different facility arrangements that may be used by the BOC. *See id.* ¶ 112.

[166] *Id.*, ¶ 93.

[167] *Id.*

[168] *Id.*, ¶ 88.

pricing" and that price cap regulation of long distance services could deter attempts to raise rivals' costs.[170] Similarly, the Commission has recognized that federal tariffing of advanced services enabled the Commission "successfully [to] forestall[] attempts by incumbent LECs to shift costs to monopoly services in order to justify rates that effect a price squeeze."[171]

As described below, the Commission determined that BOC interLATA affiliates should be treated as nondominant in the *LEC Classification Order* based on the existence of other safeguards that no longer exist or would not apply following any sunset of section 272. In the absence of those other safeguards, the BOCs should be regulated as dominant if they provide local and long distance services through a single entity. Price squeeze conduct and misallocation of costs by BOC interLATA affiliates since 1997, and the heightened incentives to engage in such conduct if the BOCs provide local and interLATA services on an integrated basis, underscore the critical need for the dominant carrier regulation required by the BOCs' market power over local exchange and exchange access following any removal of section 272.

2. Section 208 Fails to Provide an Adequate Substitute for Dominant Carrier Regulation.

The Commission cannot reasonably rely on the section 208 complaint process to prevent BOC abuse of their local bottlenecks.[172] By the time the complaint process has run its course, the damage to competition is done. Verizon and SBC have demonstrated that BOCs

[169] *LEC Classification Order*, ¶ 87.

[170] *Id. See also, id.*, n.338 (noting that "the tariff filing requirement might help detect certain types of price discrimination).

[171] Memorandum Opinion and Order, *GTE Tel. Operating Cos.*, , 13 FCC Rcd. 22466, ¶ 32 (1998); *see also* Memorandum Opinion and Order, *Bell Atlantic Tel. Cos.*, , 1998 WL 823494 (FCC), ¶ 14 (1998).

may boost market share by 30 points or more during the 12-24 months it may take the Commission to address an IXC complaint.[173] Moreover, the BOCs have shown they are willing to breach and endlessly litigate enforcement of even their clearest legal obligations, as reflected in the Commission's record-setting fine last year against SBC for "willful and repeated[]" violations of SBC/Ameritech merger conditions.[174]

Accordingly, the Commission should not -- and cannot -- rely on the complaint process to remedy BOC anticompetitive abuse of their bottleneck facilities resulting from an overly-permissive regulatory scheme. The courts of appeals have held that the existence of a "safety valve" that permits a variance from a generally applicable regulatory scheme does not excuse an agency from failing to address a systemic problem inherent in the underlying regulatory scheme. For example, in *Time Warner Entertainment Co., L.P.* v. *FCC,* 56 F.3d 151 (D.C. Cir. 1995), the court of appeals considered a challenge to a provision of the Commission's rate-cap regime for cable television. The Commission failed to permit recovery of cost increases incurred in the period between the date on which the baseline rates were set and the effective date of the regulations.[175] The court rejected the Commission's attempt to justify its decision on the grounds that disadvantaged cable companies could always seek the imposition of cost-of-service ratemaking. Because that option "is costly . . . and is intended to be a limited

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[172] *See* 47 U.S.C. § 208.

[173] Selwyn Dec., ¶ 102.

[174] SBC Communications, Inc., Apparent Liability for Forfeiture, File No. EB-01-IH-0030, FCC 02-282 (rel. Oct. 9, 2002), ¶ 1. *See also, id.*, ¶ 24 ("In state after state, throughout the Ameritech region, SBC forces competing carriers to expend time and resources in state proceedings trying to obtain what SBC was already obligated to offer, causing delays in the availability of shared transport.")

'safety-valve' exception," the court held that it cannot be a widely-used mechanism for correcting an imprudent rate scheme.[176]

3. **U.S. Trade Commitments Require Regulatory Safeguards to Prevent Anticompetitive Practices by BOCs and ILECs.**

Dominant carrier regulation or other regulatory safeguards preventing such anticompetitive practices are also required by U.S. multilateral trade obligations. The WTO commitments on basic telecommunications services made by the United States under the General Agreement on Trade in Services include the regulatory obligations contained in the Reference Paper.[177] Section 1 of the Reference Paper requires the United States to maintain "[a]ppropriate measures . . . for the purpose of preventing suppliers who, alone or together, are a major supplier from engaging in or continuing anti-competitive practices."[178] Anticompetitive practices "include in particular . . . engaging in anticompetitive cross-subsidization."[179] A "major supplier is a supplier which has the ability to materially affect the terms of participation (having regard to price and supply) in the relevant market for basic telecommunications

[175] *See Time Warner*, 56 F.3d at 173.

[176] *Id.*; *see also Ass'n of Oil Pipelines* v. *FERC*, 281 F.3d 239, 244 (D.C. Cir. 2002); *American Gas Ass'n* v. *FERC*, 912 F.2d 1496, 1517-18 (D.C. Cir. 1990); *ALLTEL Corp.* v. *FCC*, 838 F.2d 551, 561 (D.C. Cir. 1988).

[177] United States, Schedule of Specific Commitments, World Trade Organization, Fourth Protocol to the General Agreement on Trade in Services, GATS/SC/90/Suppl.2, Apr. 15, 1997, at 4-6.

[178] *Id.* at 4. *See also, Foreign Participation Order*, ¶ 340.

[179] United States, Schedule of Specific Commitments, World Trade Organization, Fourth Protocol to the General Agreement on Trade in Services, GATS/SC/90/Suppl.2, Apr. 15, 1997, at 4.

services" resulting from either "control over essential facilities" or "use of its position in the market."[180]

The Commission has acknowledged that "Section 1 of the Reference Paper . . . requires us to maintain measures that would prohibit anticompetitive activity of suppliers, which alone or together, constitute a 'major supplier.'"[181] The Commission has further emphasized that "the Reference Paper explicitly imposes an obligation on WTO Members which adopted it to take actions to prohibit anticompetitive behavior."[182] In fact, the United States has brought a WTO Dispute Settlement Body complaint against Mexico alleging, among other things, that the Government of Mexico has failed to comply with its obligations under section 1 of the Reference Paper.[183] The Commission also has affirmed that its Section 63.10 dominant carrier rules for U.S. affiliates of carriers with market power at the foreign end of U.S. international routes "are designed to do exactly that – deter anticompetitive behavior by carriers that, alone or together, control 'essential facilities or otherwise have the ability to affect the market adversely.'"[184]

Because the ILECs also control essential facilities and thus have the ability to affect the market adversely, the Commission is required by the Reference Paper to maintain measures to prevent the ILECs "from engaging in or continuing anti-competitive practices." As

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[180] *Id. See also, Foreign Participation Order*, ¶ 340, n.693.

[181] *Id.*, ¶ 358.

[182] *Id.*, ¶ 372.

[183] *See* Letter, dated Feb. 13, 2002, to H.E. Mr. Kare Bryn, Chairman, Dispute Settlement Body, World Trade Organization, from Ambassador Linnet F. Deily, Office of the United States Trade Representative.

[184] *Id.*, ¶ 372.

described above, BOC and ILEC control of upstream essential facilities is no different from the control of upstream essential facilities by the U.S. affiliates of carriers with market power in foreign markets. The ILECs, therefore, indisputably are also "major suppliers" under the Reference Paper. Moreover, the many U.S. affiliates of foreign carriers from WTO Member countries that have entered the U.S. market in recent years require access to the ILEC local bottlenecks to originate and terminate services in the U.S. market and are adversely affected by ILEC anticompetitive practices.[185]

Thus, in the absence of the regulatory basis for the nondominant treatment adopted in the *LEC Classification Order*, the Commission is required by U.S. WTO commitments to take affirmative measures to prevent ILEC abuse of the market power conferred by their local bottlenecks.

IV. CHANGED CIRCUMSTANCES REQUIRE A DIFFERENT APPROACH FROM THAT TAKEN BY THE *LEC CLASSIFICATION ORDER*.

The key predicates for according nondominant treatment to the BOC long distance affiliates in the *LEC Classification Order* would no longer apply after any sunset of section 272. As a result, the Commission is obliged to take these and other changed circumstances into account in making its decision here.

The Notice acknowledges (¶ 7) that the Commission's existing non-dominant treatment of BOC long-distance affiliates was "*predicated* on the presence of a section 272 separate affiliate and full compliance with the structural, transactional and nondiscrimination

[185] *See, e.g.*, Comments of Cable & Wireless USA, Inc., RM Docket No. 10593, Dec. 2, 2002, at 7 (noting that "Cable & Wireless remains a captive customer of the BOCs with respect to the vast majority of the buildings Cable & Wireless must reach to provide its own customers with
(continued . . .)